

Office of Internal Audit



Louisville, Kentucky

The Office of Internal Audit provides independent, objective assurance and consulting services that add value to and improve the City of Louisville's operations.

Photo by Laura Hartford

Louisville Metro
Government

Vendor Payment
Threshold Compliance





Audit Report

Louisville Metro Government

Vendor Payment Threshold Compliance

April 2005

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CHIEF AUDIT EXECUTIVE

Transmittal Letter

April 27, 2005

The Honorable Jerry E. Abramson
Mayor of Louisville Metro
Louisville Metro Hall
Louisville, KY 40202

Re: Compliance Review of Vendor Payment Activity

Introduction

We performed a compliance review of vendor payment activity. The primary focus was compliance with threshold requirements, i.e., that transactions exceeding the limits were processed appropriately. The basis for the requirements includes both statutory (e.g., KRS) and internal policies and procedures. The focus of this review included:

- Aggregate payments to vendors exceeding \$10,000
- Individual invoices exceeding \$2,500
- Compliance with terms specified in authorizing documents (e.g., contract, grant)

The review also included the assessment of methods used to monitor this activity.

Our examination was conducted in accordance with Government Auditing Standards issued by the Comptroller General of the United States and with the Standards for the Professional Practice of Internal Auditing issued by the Institute of Internal Auditors.

As a part of the review, the internal control structure was evaluated. The objective of internal control is to provide reasonable, but not absolute, assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with applicable laws and regulations
- Safeguarding of assets

There are inherent limitations in any system of internal control. Errors may result from misunderstanding of instructions, mistakes of judgment, carelessness, or other personnel

factors. Some controls may be circumvented by collusion. Similarly, management may circumvent control procedures by administrative oversight.

Scope

Louisville Metro's procurement policies and procedures were reviewed. Interviews of key personnel were conducted. The focus of the review was compliance with threshold requirements, i.e., that transactions exceeding the limits were processed appropriately. For this review, two thresholds were the focus.

- Aggregate payments to vendors exceeding \$10,000
- Individual invoices exceeding \$2,500

Payments exceeding these thresholds should be authorized by a purchase order administered by either the Department of Finance or the Department of Purchasing. For this review, the \$10,000 threshold was applied cumulatively, not on an individual departmental basis.

A sample of payment transactions was reviewed. The sample was chosen from the period July 1, 2004 through September 30, 2004. This period was chosen to allow enough time to have passed since the implementation of Louisville Metro's new financial system (LeAP). This helps ensure that there has been enough time to address issues that routinely accompany system implementations, but still allows for identification of concerns before they become systemic. Metro began using the LeAP system in July 2003.

The review included assessing whether transactions were processed in compliance with requirements. This included both Metro policies as well as contractual requirements. The procedures for monitoring the payment thresholds were also reviewed. The details of the scope and methodology of the review will be addressed in the Observations and Recommendations section of this report. Our examination would not reveal all non-compliance issues because it was based on selective review of data.

Opinion

It is our opinion that compliance with vendor payment thresholds could be improved. The internal controls that help ensure compliance are weak and could be improved. The internal control rating is on page 5 of this report. This rating quantifies our opinion regarding the internal controls, and identifies areas requiring corrective action.

Opportunities to strengthen compliance were noted in several areas. Examples of these include the following.

Aggregate Payments to Vendors. The LeAP financial system does not monitor the \$10,000 limit. Monitoring has to be manually done within the Department of Finance. Since this is not "real-time", departments can initiate purchases without realizing the threshold has been exceeded. The \$10,000 threshold is a statutory limit.

Thresholds. While the LeAP financial system does monitor the \$2,500 invoice limit, noncompliance issues still exist. Since the financial system monitoring is basically after the purchase has been initiated, it is not an effective control by itself. The Departments need to be responsible for ensuring the procurement limits are properly followed.

Policies and Procedures. The procurement policies and procedures are incomplete. Procedures appear to have evolved without policy authorization, and / or based on old City or County policies. For example, several exceptions to the thresholds are “understood” but are not documented. This includes payments for insurance settlements, and for goods purchased from retail stores. The lack of comprehensive policies increases the risk of inconsistency among the departments and noncompliance with requirements.

Payment Authorization. Authorization for procurement may be in a variety of formats, including a contract, a grant, or a quote. Regardless of the format, the activity should comply with the requirements in the authorization. Compliance issues include using a contract as the authorization to pay for goods, even though the particular items are not in the contract.

The implementation of the recommendations in this report will help improve the internal controls and compliance with vendor payment thresholds.

Corrective Action Plan

Representatives from both Metro Finance and Metro General Services Administration (GSA) have reviewed the results. Both Departments are committed to addressing the issues noted. Metro Finance’s corrective action plan is included in this report as responses in the Observations and Recommendations section. In addition, a work group will be convened in July 2005 to address the more systemic issues and policy requirements. We will continue to work with Finance and GSA to ensure the actions taken are effective to address the issues noted.

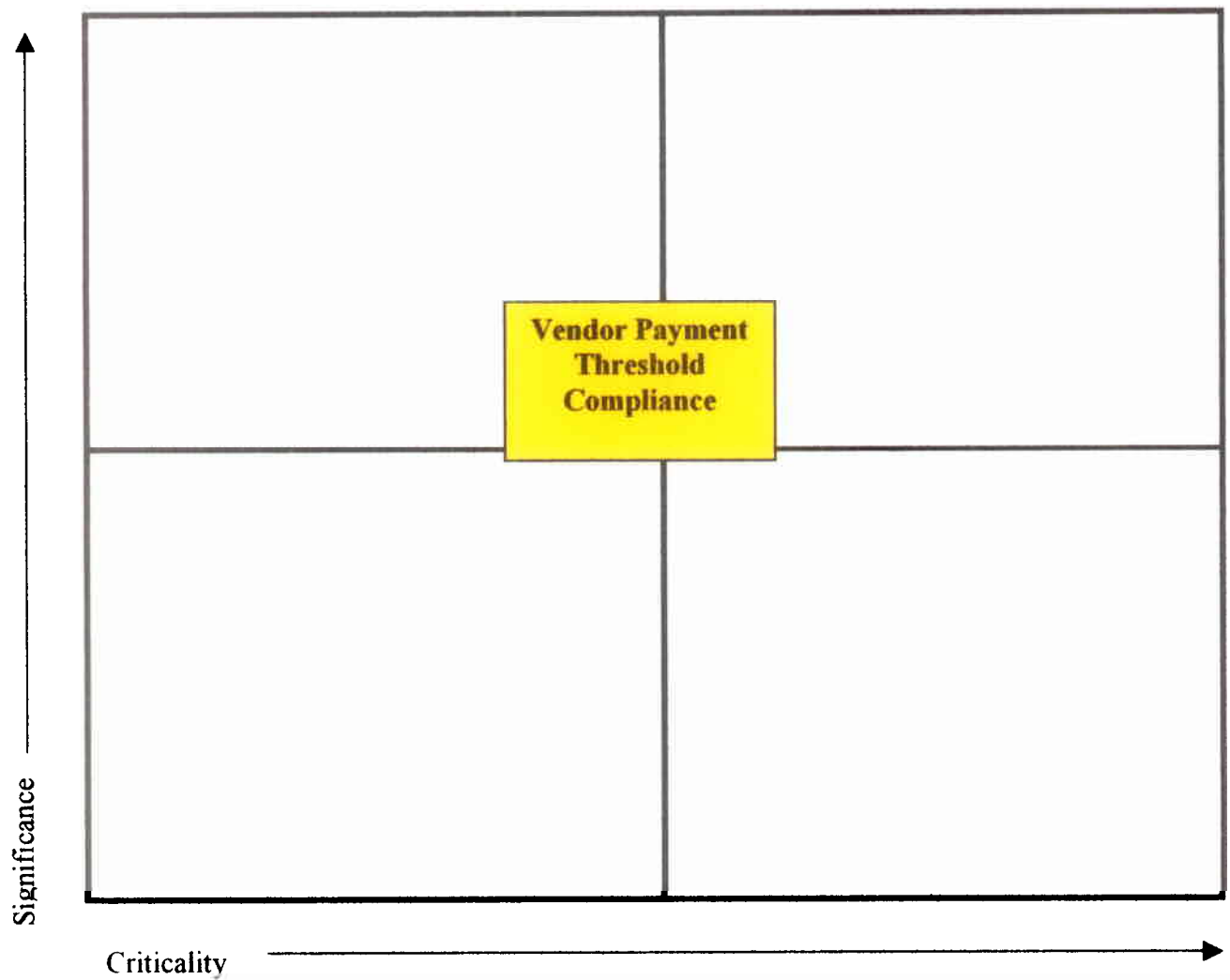
Sincerely,



Michael S. Norman, CIA
Chief Audit Executive

cc: Louisville Metro Council Audit Committee
Louisville Metro Council Members
Deputy Mayors
Secretary of the Cabinet for Finance and Administration
Chief Financial Officer
Director of General Services Administration
Director of GSA Procurement and Business Affairs

Internal Control Rating



	<u>Legend</u>		
<u>Criteria</u>	<u>Satisfactory</u>	<u>Weak</u>	<u>Inadequate</u>
<u>Issues</u>	Not likely to impact operations.	Impact on operations likely contained.	Impact on operations likely widespread or compounding.
<u>Controls</u>	Effective.	Opportunity exists to improve effectiveness.	Do not exist or are not reliable.
<u>Policy Compliance</u>	Non-compliance issues are minor.	Non-compliance issues may be systemic.	Non-compliance issues are pervasive, significant, or have severe consequences.
<u>Image</u>	No, or low, level of risk.	Potential for damage.	Severe risk of damage.
<u>Corrective Action</u>	May be necessary.	Prompt.	Immediate.

Background

Louisville Metro Government's procurement policies are based on the provisions of KRS 45a.343 through 460, and KRS 67C.117(6). The policies are designed to promote sound business practices. Metro Department employees with specific procurement authority are responsible for ensuring the Metro policies are followed. The Metro purchasing policies and procedures are specific to several types of expenditures for goods, services, and real estate.

Goods

There are three primary methods of purchasing goods.

1. Purchases under \$10,000 are made using one of the two methods.
 - Less than \$2,500, the Metro Agency may buy directly from a vendor.
 - Between \$2,500 and \$10,000, the Purchasing Department facilitates the transaction using the price quote procedures.
2. Purchases above \$10,000 are made using Competitive Sealed Bidding, Competitive Negotiation, or Noncompetitive Negotiation (e.g., sole source, emergency purchases). In general, bidding should be used for transactions above \$10,000.
3. Purchases using State price contracts.

Services

There are four primary methods of purchasing services.

1. Purchases of licensed and non-licensed (e.g., artist) professional services \$10,000 or less use the Intent to Purchase Services procedure.
2. Purchases of licensed and non-licensed (e.g., artist) professional services of \$10,000 or more use the Professional Services Contract procedure.
3. Purchases of skilled trade services (e.g., plumber, electrician):
 - Between \$2,500 and \$10,000, the Purchasing Department facilitates the transaction using the price quote procedures.
 - Purchases above \$10,000 are made using Competitive Sealed Bidding or Competitive Negotiation.
4. Purchases using State price contracts.

Real Estate

There are four primary methods of purchasing or selling real estate.

1. Competitive Sealed Bidding
2. Competitive Negotiation
3. Noncompetitive Negotiation
4. Legislative action of the Metro Council

Summary of Audit Results

I. Current Audit Results

See Observations and Recommendations section of this report.

II. Prior Audit Issues

The Office of Internal Audit has not performed compliance reviews of vendor payment threshold activity in the LeAP financial system. This audit was scheduled to allow enough time to have passed since the implementation of the LeAP financial system. This helps ensure that there has been enough time to address issues that routinely accompany system implementations, but still allows for identification of concerns before they become systemic. Metro began using the LeAP system in July 2003.

III. Statement of Auditing Standards

Our audit was performed in accordance with Government Auditing Standards issued by the Comptroller General of the United States and with the Standards for the Professional Practice of Internal Auditing issued by the Institute of Internal Auditors.

IV. Statement of Internal Control

We conducted a formal study of the internal control structure in order to obtain a sufficient understanding to support our final opinion.

V. Statement of Irregularities, Illegal Acts, and Other Noncompliance

Our examination did not disclose any instances of irregularities, any indications of illegal acts, and nothing came to our attention during the examination that would indicate evidence of such. Any significant instances of noncompliance with laws and regulations are reported in the Observations and Recommendations section of this report.

VI. Views of Responsible Officials / Action Plan

An exit conference was held on April 6, 2005. Attending were Sara Parks, Kevin Moore, and Robin Grammer representing Metro Finance; Michael Norman and Mark Doran representing the Office of Internal Audit. The views of Metro Finance officials are included as responses in the Observations and Recommendations section of the report.

An exit conference was held on April 25, 2005. Attending were Susan Neumayer, and Craig Bowen representing Metro General Services Administration; Michael Norman and Mark Doran representing the Office of Internal Audit.

Both Metro Finance and Metro General Services Administration are committed to addressing the issues noted. In July 2005, a work group will be convened to address the more systemic issues and policy requirements.

Observations and Recommendations

Scope

Louisville Metro's procurement policies and procedures were reviewed. Interviews of key personnel were conducted. The focus of the review was compliance with threshold requirements, i.e., that transactions exceeding the limits were processed appropriately. The procedures for monitoring the payment thresholds were also reviewed.

A sample of payment transactions was reviewed. The sample was chosen from the period July 1, 2004 through September 30, 2004. This period was chosen to allow enough time to have passed since the implementation of Louisville Metro's new financial system (LeAP). Metro began using the LeAP system in July 2003. The sample was chosen from the accounts payable transactions in the LeAP system. This does not include transactions processed outside of the accounts payable system, such as electronic bank transfers. The transactions chosen exceed one of the thresholds. For this review, the \$10,000 threshold was applied cumulatively, not on an individual departmental basis. Our examination would not reveal all non-compliance issues because it was based on selective review of data.

The review focused on determining if transactions were processed in compliance with requirements. This included both Metro policies as well as other requirements (e.g., contracts, grants, bid awards). Three separate data sets were reviewed.

\$10,000 Threshold

Ten vendors with aggregate payments exceeding \$10,000 were chosen and individual transactions were reviewed. While the aggregate \$10,000 threshold applies to annual expenditures, this review only considered activity for the first quarter of fiscal year 2005.

\$2,500 Threshold

Twenty-five individual vendor invoices that were greater than \$2,500 were reviewed.

Compliance with Other Requirements

A sample of twenty individual transactions was reviewed to determine compliance with the purchase order documentation (e.g., contracts, grants, price quotes).

Observations

There were several opportunities noted for improving compliance with vendor payment thresholds. The internal controls that help ensure compliance are weak. The observations are as follows:

1. Monitoring of Aggregate Payments
2. Policies and Procedures
3. Compliance
 - (A) Thresholds
 - (B) Other Requirements

Details of these begin on the following page.

#1 - Monitoring of Aggregate Payments

Monitoring of aggregate vendor payments is not adequate. There are not adequate controls in place to ensure that the aggregate vendor payment threshold of \$10,000 is not exceeded without proper authorization (e.g., contract).

- The LeAP financial system does not automatically monitor aggregate payments to vendors. Metro Finance staff explained that automatic monitoring of aggregate payments would have required extensive customization to the financial system, which would have increased the cost of implementation. In addition, customization complicates the application of system upgrades when needed. Due to these issues, management determined that automated aggregate payment monitoring would not be used.
- Metro Finance staff manually monitors some activity, such as Intent to Purchase Services transactions. This is not adequate since all activity is not included. Manual oversight may not be the most efficient and effective manner to monitor aggregate payments to vendors.
- There is not an effective way for the various Metro Departments to be aware of the status of individual vendor thresholds. Therefore, the departments could initiate a transaction unaware that the threshold will be exceeded because of activity of others.

Monitoring of activity is a critical control in helping mitigate non-compliance risk. The non-compliance consequences may be severe since the threshold is based on legal requirements.

Recommendations

Appropriate personnel should take corrective action to address the concerns noted. Specific recommendations include the following.

- ✓ The feasibility of incorporating policy requirements and limitations into the LeAP system should be investigated. The cost / benefit of changing the functionality of the LeAP financial system should be evaluated, as well as the potential exposure for non-compliance.
- ✓ Finance Department personnel were recently trained in LeAP (Oracle) report writing. This training may help identify ways in which the current LeAP functionality may be used to monitor aggregate payments. This may be in the form of using existing reports, or developing new reports, to use as monitoring tools.
- ✓ If the analysis shows it is better to keep the system as is, additional compensating controls will be necessary. This includes formal monitoring procedures for the Finance Department to use that are routine, consistent, and include all payment activity.
- ✓ Louisville Metro Departments should be held accountable for adhering to vendor payment thresholds. However, they need to have the ability to determine if a vendor payment threshold will be exceeded prior to initiating a transaction. This provides an opportunity to follow the appropriate procurement policies and procedures. The best way to provide this ability needs to be determined.

- ✓ Additional training of key personnel in all departments may be beneficial, especially as changes are implemented. This includes all staff involved with procurement activities, not just the departments' business office personnel. Training may also be beneficial for Purchasing and Finance personnel.

Metro Finance Department's Response

Finance staff has continued to make improvements and changes in practices during the past year to assist Accounts Payable staff with ensuring transactions are processed in accordance with purchasing policies. It is important to note that Accounts Payable is a processing division and while Finance has published the financial policies, Purchasing is designated by the Mayor as responsible for issuing and administering sound purchasing policies for Metro Government.

Finance staff fully agrees that Metro Departments should be held accountable for adhering to vendor payment thresholds. Directives requiring procurement compliance must come from the Administration, Cabinet Secretaries and Department Directors. Finance is not able to force compliance; we can monitor and notify departments of aggregate limit issues after they occur. In order to assist Departments with monitoring aggregate payment levels a monitoring report has been developed and will be provided to business managers at the April 2005 Business Managers meeting. This report will allow business managers and their staff to run a supplier payment history report for all suppliers paid \$10,000 or more in a fiscal year. At this time it is not feasible to build real time intelligence in to the system to monitor payment thresholds.

#2 - Policies and Procedures

Louisville Metro's procurement policies and procedures are not comprehensive enough to address the practices followed in processing day-to-day activity. Thus, Metro personnel, including the Finance Department and the Purchasing Department, rely on unofficial guidelines such as "word-of-mouth", and / or former City or County policies. This weakens the control structure for the activity. Examples of these include the following.

- **Policy Exceptions.** Some transactions that exceed the payment thresholds are "understood" as being acceptable to process without complying with procurement policies. Examples include the following.
 - *Insurance and liability claims; Loan program payments; Membership dues.* While these types of exceptions are understandable, they are not documented in the policies and procedures.
 - *Retail establishments; Travel Agents.* Purchasing Department staff explained that these types of transactions cannot be bid. This includes goods purchased at retail establishments like home supply stores, and the use of travel agents for purchasing airline tickets. Not only are these not documented in the policies and procedures, but this practice may result in Louisville Metro paying more for goods / services than if competitive bidding were used.
- **Purchase Orders.** Purchase orders within the LeAP system are used to identify certain types of transactions, and to help ensure compliance with policies and procedures. This is a fundamental control component, but it is not totally effective.
 - The lack of a purchase order within LeAP does not mean that the transaction was processed improperly. All other requirements may have been complied with, except obtaining / recording the purchase order number.
 - Purchase order information within LeAP is used to identify Professional Service Contracts (PSCs). These are reported to the Metro Council on a routine basis. However, PSCs may be processed without use of a purchase order. In these cases, there is no mechanism in place to ensure the PSC is identified for reporting purposes.
- **Outside Entities / Other Elected Officials.** Procurement activity is processed for various entities using the LeAP system. These entities are not part of Louisville Metro Government. This includes non-elected offices, such as the Board of Elections, as well as elected offices, such as the Coroner.

Louisville Metro's responsibility for this activity is not documented. It has not been determined if these entities are required to comply with Metro procurement policies and procedures or if Louisville Metro is simply a processing agent. The Office of Internal Audit has been consulting with the Metro Finance Department to address this situation, but a final determination has not been made.

The lack of comprehensive policies and procedures greatly increases the risk of non-compliance since processing inconsistencies will result. Documented policies and procedures, with allowable exceptions noted, are a fundamental control for procurement activity.

Recommendations

Appropriate personnel should take corrective action to address the concerns noted. Specific recommendations include the following.

- ✓ Louisville Metro Procurement policies and procedures should be revised. The revision should focus on addressing the daily activities that are currently omitted. Current practices should not be automatically adopted as policy without evaluating their risks and benefits. This includes the practice of not seeking bids for goods purchased at home supply stores, and the use of travel agents.
- ✓ The revised policies and procedures should be disseminated to all departments. Training of key personnel may also be necessary.
- ✓ The Finance Department should monitor payment transactions to help ensure compliance with policies and procedures. This includes verifying that authorized individuals approve transactions and that the appropriate purchase orders were established. Departments should be held accountable for non-compliance activity.
- ✓ Exceptions to established policies and procedures should be thoroughly documented. This includes approval for the exception. This documentation should be retained with the other payment documentation in Metro Finance.
- ✓ A determination should be made as to responsibility and accountability for outside entity payment activity. A formal agreement should be in place that clearly states each party's responsibilities and requirements for policy compliance. The Office of Internal Audit will continue working with Metro Finance to resolve this issue.

Metro Finance Department's Response

The policies and procedures are a living document and revisions are made as needs are identified. In fact several revisions have been implemented since the policies were originally issued and we currently have one revision in process. While we understand the desire to have a list of exceptions we have determined that our business practice is for the policy document to state what purchases are allowable (goods and services) and not apply it to the exception items, many of which are not purchases but legally required payments. It is possible that Purchasing could issue blanket sole source numbers for items such as loan program payment, claims and judgments and membership dues etc. as was past practice.

With regard to training of key personnel, Finance staff currently offers multiple training programs through the Leap office. Supplemental training could be addressed by Purchasing staff with a focus on competitive bidding requirements and the policy aspects of purchasing goods and services. In addition, policy changes are announced and training materials are provided at the monthly business managers meeting. Individual personalized training is provided upon request and additional "hot topic" training classes are offered as needs are identified.

With regard to the comment on outside entity payment activity that issue is under review by the Executive Administrator of Accounting. She will be working with Internal Audit and management to formulate a policy recommendation in the near future.

#3 - Compliance

A) Payment Authorizations (Contracts, Grants, Bid Quotes)

Supporting documentation for purchase orders was requested and compared with the individual invoice payments. The purpose was to determine compliance with the purchase order documentation (e.g., contracts, grants, price quotes). Several issues were noted that indicate weaknesses in the control structure.

- In four of the twenty payments examined, the invoice did not comply with the related purchase order documentation. For example, one of the invoices was for a lease payment for a type of vehicle that was not covered in the contract.
- For four of the payments examined, the official custodian (either the Finance Department or the Purchasing Department) could not provide the purchase order documentation for the transaction. The inability to provide complete documentation weakens the ability to monitor activity, and may result in the inability to sufficiently document the business purpose of transactions.
- In one case, the payment documentation in Metro Finance did not include a signed loan agreement authorizing the payment. The payment document was properly authorized and included an unsigned loan payment receipt. A signed copy of the loan agreement was available in the Budget Division of Metro Finance.
- For one payment, the documentation in Metro Finance did not contain the vendor invoice. A copy of the invoice was available from the department that initiated the transaction.

These illustrate the weaknesses in the internal control structure. The failure to comply with requirements, such as contractual terms, creates an unnecessary risk exposure for Louisville Metro. It may also result in decreased economic benefits (e.g., contract rates, discounts).

B) Thresholds

Compliance with the vendor payment thresholds was reviewed using data in the LeAP system. The following instances of noncompliance were noted.

- **\$10,000 Threshold.** The payment activity for one of the ten vendors reviewed exceeded the \$10,000 aggregate limit. Since purchase orders were not recorded in the financial system, it appears this activity was not authorized by a contract, grant, bid quote, etc. Adherence with policies would require one of these types of purchasing methods be used once the aggregate threshold was met.
- **\$2,500 Threshold.** Seven of the twenty-five individual invoices reviewed exceeded the \$2,500 limit. Since purchase orders were not recorded in the financial system, it appears this activity was not authorized by a contract, grant, bid quote, etc. Adherence with policies would require one of these types of purchasing methods be used once the threshold was met. Examples include the following.
 - Four of the seven cases involved exceptions that are not documented in the policies and procedures. This issue was addressed in Observation #2.

- In one of the cases, a Professional Service Contract was attached to the payment documentation, but there was not a purchase order recorded in the LeAP system.

These illustrate the results of the weaknesses previously noted in the internal control structure.

Recommendations

Appropriate personnel should take corrective action to address the concerns noted. Specific recommendations include the following.

- ✓ The importance of adhering to procurement policies and procedures should be stressed to all Louisville Metro personnel. This includes understanding the thresholds and various guidelines for procuring goods and services. Individuals purchasing goods / services and approving payments are responsible for ensuring compliance with guidelines and agreements. They may also be responsible for maintaining complete purchase order documentation. Additional training may be necessary, especially for personnel with purchasing responsibilities that are not in the departments' business offices.
- ✓ All applicable payment documents should note the contract / purchase order number as required by Metro policies and procedures. This applies to transactions involving any contract vendors, sole source providers and purchases exceeding designated thresholds. This helps in the monitoring of contract activity for payment limitations and adherence to established agreements. It also provides for better fund management in allowing encumbrances / commitments for future payments.
- ✓ Departmental managers responsible for approving payments should ensure applicable requirements / terms have been followed. This may require reviewing supporting documentation, such as the actual contract.
- ✓ The Department of Finance should monitor payment transactions to help ensure compliance with applicable policies and procedures. This includes verifying that authorized individuals approve transactions and that the appropriate purchase orders were established.
- ✓ Exceptions to established policies and procedures should be thoroughly documented. This includes approval for the exception. This documentation should be retained with the other payment documentation in Metro Finance.
- ✓ Original documentation (invoices, contracts, grants, bid quotes) should be maintained by the official custodian (either the Finance Department or Purchasing Department) in a centralized file. This is necessary to ensure that various requirements (e.g., KRS) are satisfied.
- ✓ To the extent possible, departments should be trained to use the LeAP system to determine the amount of payments to a vendor so they can determine if a threshold will be exceeded prior to initiating a transaction.

Metro Finance Department's Response

Comments on compliance have been addressed in the responses to recommendations one and two.